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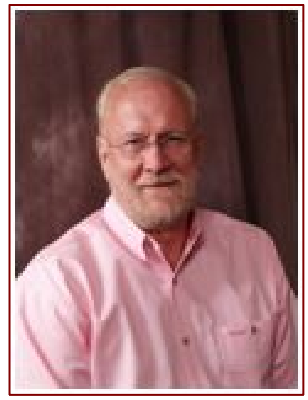

Memo

From: Terry Whiteside

To: **Montana Wheat & Barley Committee**

Date: November 5, 2008

Re: Transportation Report

NATIONAL AND REGIONAL SHIPPERS COME TOGETHER TO PETITION FOR REVIEW OF STB SMALL RATE CASE RULES

Last week, twenty-five national and regional shipper groups led by the National Industrial Transportation League and the Alliance for Rail Competition submitted a petition before the U.S. Court of Appeals for the District of Columbia Circuit to review a final rulemaking decision of the Surface Transportation Board in STB Ex Parte No. 646 Simplified Standards for Rail Rate Cases. Most of the groups had participated on behalf of its members in the rulemaking proceedings before the STB regarding this case earlier this year and in 2007. Rail shippers have the right to challenge the reasonableness of their rail transportation rates under the standards and procedures adopted by the Board in Simplified Standards. The petitioners were: The National Industrial Transportation League, National Grain and Feed Association, Alliance for Rail Competition, American Chemistry Council, The Fertilizer Institute, Colorado Wheat Administrative Committee, Colorado Wheat Growers Association, Consumers United for Rail Equity, Idaho Barley Commission, Idaho Grain Producers Association, Idaho Wheat Commission, Montana Grain Growers Association, Montana Wheat and Barley Committee, National Association of Wheat Growers, National Barley Growers Association, Nebraska Wheat Board, Nebraska Wheat Growers Association, North Dakota Grain Dealers Association, North Dakota Public Service Commission, North Dakota Wheat Commission, Oklahoma Wheat Commission, South Dakota Wheat Commission, South Dakota Wheat Inc., Texas Wheat Producers Board, Texas Wheat Producers Association, Washington Wheat Commission, and the Honorable Brian Schweitzer, Governor, State of Montana.

The specific issues as listed in the filing are:

1. Whether the Board's failure to determine if the levels of the relief caps for Three-Benchmark and Simplified-Stand Alone Case (SAC) presentations provide a simplified and expedited method for challenging the reasonableness of rail rates for *all* cases when a Full-SAC presentation is too costly, given the value of the case, was arbitrary, capricious, and not in accordance with current statute.
2. Whether the Simplified-SAC methodology is an arbitrary and capricious departure from Board precedent without a cogent explanation.

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While the Simplified-SAC is supposed to provide a similar relief to a shipper without the enormous and often prohibitive costs of the Full-SAC, in reality the present simplified approach gives results that are always considerably higher than the 180% Revenue to Variable Cost threshold. If, as a result of this petition, the Court sides with the shippers, STB will have to develop a method that would provide results that are more comparable with those of the Full-SAC method.

BNSF AND TWO MONTANA GROUPS – FORGE A MEDIATION/ARBITRATION PLAN FOR MONTANA FARM PRODUCERS

The Montana Grain Growers and the Montana Farm Bureau have announced last week an Mediation/Arbitration draft plan covering wheat and barley movements greater than 250 miles on BNSF.

The draft plan is still being worked on – and will be presented to the membership of both organizations over the next couple of months. Why the details are still being worked on – the most important concept in any good arbitration process, that has a number of parts, is to develop an arbitration process that has fair rules for both parties. This is especially important in this farm vs. BNSF process, given that the BNSF is a possessor of a huge well of knowledge of railroad, costing and its operations and the farm producer while knowledgeable about the marketing of grain are not as experienced at bringing rate challenges.

There are concerns with the process as proposed, for example, the arbitration process may include allowing BNSF to mount a product or geographic competition defense – a process that has been eliminated by the STB in its deliberations partly due to concerns about fairness.

All in all this is progress. As Kevin Kauffman stated at the NAWG meeting in Dallas last week, this would not have come about without the considerable political pressure by Montana politicians. W&A believes this process will provide a complementary addition to the national rail competition efforts – especially given that it provides direct producer access to relief. The national rail competition efforts continue to seek a final offer arbitration (FOA) process – which is utilized in Canada to settle rate and service disputes between shippers and railroads. The FOA sets a standard of the 'most' reasonable rate standard selection. FOA has defined outcomes – where the arbitrator picks either the shipper or the carriers proposed rate. The FOA process has been adopted by the STB is some of its newest processes and is mandated in government at the FCC for certain disputes. It is a good arbitration process that levels the playing field between the shipper and the large railroad carrier.

FOA will provide negotiation leverage for grain merchandiser and elevators that they have never had before. Final Offer Arbitration has a successful track record and works, because it is used in Canada and has been successful in helping producers especially grower owned facilities. In fact, the existence of the FOA option in Canada means that, in many cases, the shipper has bargaining leverage and negotiations are successful without the need for arbitration.

Christensen Study on Rail Competition

On Monday, November 3rd, the Surface Transportation Board released the results of the Christensen Competition Survey, which will be the topic of discussion at STB hearings to be held on Thursday, Nov 6th at 10 a.m. **STB TO REVIEW COMPETITION STUDY ON NOVEMBER 8TH**

Christensen Associates has completed the STB commissioned study to provide a comprehensive analysis of rail competition, capacity and interplay between the two. The study was also supposed to

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examine various regulatory policy alternatives. The study included Christensen's quantitative research as well as interviews with various industry stakeholders.

The STB will publicly discuss the study on November 6th, at 10 a.m. in the Board's Hearing Room on the 1st Floor of the agency's headquarters at Patriots Plaza, 395 E Street, S.W., Washington, D.C. The public is invited to attend the meeting but will not be permitted to testify. The $1 Million study was commissioned a year ago by the STB after it received a GOA review that urged further study of captive shippers and their plight. Initially the STB balked at further study, but after continuing pressure, the STB agreed to the Christensen Study.

A review of the study finds something for everyone to hang their hat on to justify their positions: the railroads, the STB, and the captive rail customers. Listed below are some of the major findings. The study has some basic conclusions and calls for future research.

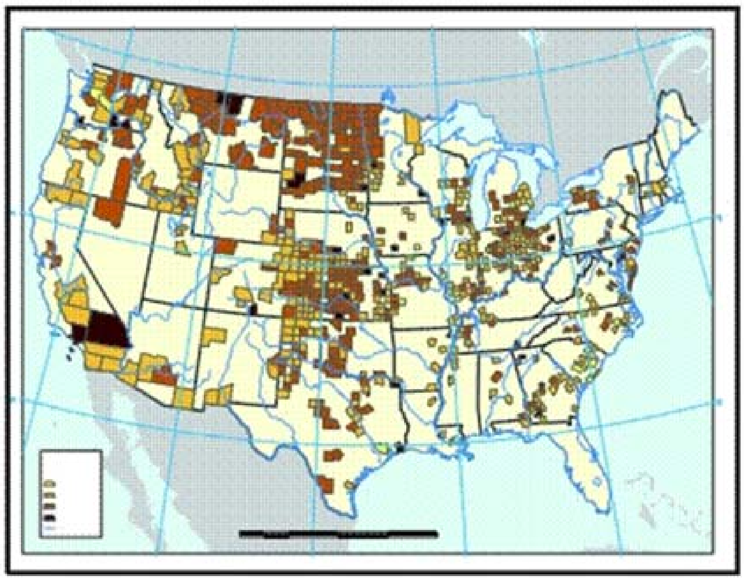

Figure ES-3 Christensen Study 10-08, R/VC Averages by County for Wheat Shipments 2001-2006 Carload Waybill Sample

- **Figure ES-3 shows the high R/VC (Revenue to Variable Cost levels) on wheat in the northern and central plains**. The study confirms that large areas of Montana, North Dakota, Oklahoma, South Dakota and Kansas contained high R/VC levels. Parts of Montana average well over 300% of variable cost for the multiple counties. These study results are consistent with studies conducted by Whiteside & Associates, Fauth and Associates, L.E.Peabody, and the GAO in the last three major studies over the last 20 years.
- **Additional pockets of concentrations of high R/VC pockets continue to exist** in California, Colorado, Idaho, Nebraska, Nevada, Minnesota, Ohio, Oregon, Indiana, Michigan and Washington.
- **Rails generally are exercising increased market power over the past few years.** The Christensen survey suggests that "the exercise of market power appears to have increased in the freight railroad industry over the last twenty years." The Christensen Study attempts to justify this increase in market power by suggesting over the last twenty years there was a need to obtain revenue sufficiency. Yet the study concludes in recent years, the railroad's revenues 'noticeably' exceed industry costs.

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- While the railroads continue to state with pride their productivity increases, the Christensen Study states that increases in revenue per ton-mile earnings which are up sharply, are coming from 'increases in railroad input prices (rates) and diminishing productivity growth. This does not suggest a declining productivity level but a slowing of the growth of productivity increases.
- **The Study concludes that Railroads have not, as yet, achieved 'revenue sufficiency'(up to 2006)**
- **Revenue / Variable cost ratio may not a sole reliable indicator of market dominance.** One of the findings of this study which is becomes a foundation for their conclusions is that a R/VC only approach for determining market dominance is not be the only factor that should be considered. They suggest direct assessment of relevant market structure in conjunction with R/VC ratios may be appropriate. Exclusive use of the revenue to variable cost ratio (R/ VC) as a metric to determine rate limits is one element of proposed rail competition legislation. The Christensen study clearly indicates that use of this metric alone may not be appropriate because it is weakly correlated with shipper captivity. However, at the same time they acknowledge as the GOA study before it – there are pockets of captivity that are troublesome. They believe that simplifying rail rate parameters (such as using only R/ VC) can cause risk for the railroads because a simple framework may lead to an artificially low rate for shipments on low density rail lines.
- **Targeted rate relief may cause pressure on other shipper groups.** The Christensen study concludes that providing significant rate relief to one group of shippers may cause upward rate pressure on other shippers or it could threaten rail financial viability. However, they continue to state that certain shippers are subject to captivity restraints.
- **The Study concludes that certain proposals may produce favorable economic benefit/cost conditions**. The study liked the more modest open-access processes such as terminal access and reciprocal switching but pushed back from quote a rate due it potential for loss of length-of-haul economics. Essentially, reciprocal switching is an approach used in Canada which provides competition by allowing a competing railroad to access a captive shipper if the railroad is within a moderate distance of the origination point of the freight. Such a measure won't eliminate captivity on the plains.
- **The study also concludes that Final Offer Arbitration with a modification** is a workable alternative that would serve to lift some regulatory burden. "To the extent that the threat or possibility of final-offer arbitration encourages parties to negotiate and reach voluntary agreement or resolve disputes…it would improve the functioning of private markets without imposing additional regulatory burdens." "One major consideration would be the requirement that potential arbitrators have expertise in the railroad industry and its economics."
- **The Study recognizes that "policies to introduce greater competition" will not necessarily benefit all shippers.** "Some shippers are truly captive because of factors such as geographic location and/or low shipper density. Therefore, effective regulatory oversight will still be important regardless of any efforts to induce greater competitive responses in the railroad industry"
- **The Study suggests further study on capacity issues, cost shifting, fuel surcharges when more data is available and the cherry picking aspects of issues related to Class II and Class III Railroads including interchange arrangement and non-competitive rates – and are Class II and Class III being under-funded.** They also question the 30 year projections on Rail Demand – stating that more study is needed on projections and future capacity needs.

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